

Below is a summary of HF Group Plc FY'2022 performance:

Balance Sheet Items	FY'2021	FY'2022	y/y change
Net loans	34.7	36.3	4.6%
Government Securities	6.6	8.5	30.4%
Total Assets	53.2	57.0	7.1%
Customer Deposits	37.7	39.8	5.5%
Deposits Per Branch	1.7	1.8	5.5%
Total Liabilities	44.9	48.2	7.3%
Shareholder's Funds	8.3	8.8	6.0%

Balance Sheet Ratios	FY'2021	FY'2022	y/y change
Loan to deposit ratio	92.0%	91.2%	(0.8%)
Government Securities to Deposits ratio	17.4%	21.5%	4.1%
Return on Average Equity	(8.1%)	3.1%	11.2%
Return on Average Assets	(1.3%)	0.5%	1.8%

Income Statement	FY'2021	FY'2022	y/y change
Net Interest Income	1.8	2.2	18.2%
Net non-Interest Income	0.5	0.9	63.5%
Total Operating income	2.4	3.0	28.5%
Loan Loss provision	(0.3)	(0.2)	(30.8%)
Total Operating expenses	(3.3)	(2.8)	(14.3%)
Profit before tax	(1.0)	0.2	119.7%
Profit after tax	(0.7)	0.3	138.9%
Core EPS	(1.8)	0.7	138.9%

Income Statement Ratios	FY'2021	FY'2022	y/y change
Yield from interest-earning assets	9.0%	9.9%	0.9%
Cost of funding	4.8%	4.9%	0.1%
Net Interest Spread	4.3%	5.0%	0.7%
Net Interest Margin	4.2%	5.0%	0.8%
Cost of Risk	11.9%	6.4%	(5.5%)
Net Interest Income as % of operating income	77.3%	71.1%	(6.2%)
Non-Funded Income as a % of operating income	22.7%	28.9%	6.2%
Cost to Income Ratio	140.1%	93.5%	(46.6%)
Cost to Income Ratio without LLP	128.3%	87.1%	(41.1%)
Cost to Assets	5.7%	4.6%	(1.1%)

Capital Adequacy Ratios	FY'2021	FY'2022	% Change
Core Capital/Total Liabilities	8.3%	8.0%	(0.3%)
Minimum Statutory ratio	8.0%	8.0%	-
Excess	0.3%	0.0%	(0.3%)
Core Capital/Total Risk Weighted Assets	8.3%	8.3%	-
Minimum Statutory ratio	10.5%	10.5%	-
Excess	(2.3%)	(2.3%)	0.1%
Total Capital/Total Risk Weighted Assets	12.1%	12.2%	0.1%
Minimum Statutory ratio	14.5%	14.5%	-
Excess	(2.4%)	(2.3%)	0.1%
Liquidity Ratio	22.9%	25.2%	2.3%
Minimum Statutory ratio	20.0%	20.0%	-
Excess	2.9%	5.2%	2.3%
Adjusted core capital/ total deposit liabilities	8.4%	8.1%	(0.3%)
Adjusted core capital/ total risk weighted assets	8.4%	8.4%	0.0%
Adjusted total capital/ total risk weighted assets	12.3%	12.4%	0.1%

Income Statement

- Core earnings per share rose by 138.9% to Kshs 0.7, from a loss of Kshs 1.8 registered in FY'2021. This was higher than our expectations of a 116.6% increase to an eps of Kshs 0.3, with the variance stemming from the 28.5% growth in total operating income to kshs 3.0 bn, higher than our expected projection of a 22.7% growth to Kshs 2.9 bn. As such, the core earnings per share performance was driven by the 28.5% growth in total operating income to Kshs 3.0 bn, from Kshs 2.4 bn in FY'2021, coupled with the 14.3% decline in total operating expenses to Kshs 2.8 bn from Kshs 3.3 bn in FY'2021,
- Total operating income increased by 28.5% to Kshs 3.0 bn, from Kshs 2.4 bn in FY'2021, driven by 18.2% increase in Net Interest Income (NII) to Kshs 2.2 bn, from Kshs 1.8 bn in FY'2021, coupled with a 63.5% increase in Non-Funded Income (NFI) to Kshs 0.9 bn, from Kshs 0.5 bn in FY'2021,
- Interest income grew by 8.8% to Kshs 4.3 bn, from Kshs 3.9 bn in FY'2021, mainly driven by a 41.3% increase in interest income earned from government securities to Kshs 0.9 bn, from Kshs 0.7 bn in FY'2021, coupled with a 2.6% increase in interest income from loans and advances to Kshs 3.3 bn, from 3.2 bn in FY'2021. However, the interest income growth was weighed down by the 51.7% decline in interest income from deposits and placements in other banking institutions to Kshs 10.5 mn, from Kshs 25.8 mn in FY'2021. Consequently, the Yield on Interest-Earning Assets (YIEA) increased to 9.9% from 9.0% in FY'2021, attributable to the 8.8% growth in trailing interest income, coupled with the 2% decline in Average Interest Earning Assets (AIEA). Trailing Interest Income refers to the performance of the interest income for the past 12 consecutive months,
- Interest expenses increased by 0.7% to Kshs 2.11 bn, from Kshs 2.10 bn in FY'2021, following a 3.9% increase in interest expense on customer deposits to Kshs 1.6 bn, from Kshs 1.5 bn recorded in FY'2021. The growth in interest expense was mitigated by a 51.7% decline in interest expense from deposits and placements to Kshs 0.1 bn, from Kshs 0.2 bn, coupled with a 6.1% reduction in other expenses to Kshs 373.3 mn, from Kshs 397.8 mn in FY'2021. Consequently, the Cost of funds (COF) increased by 0.1% points to 4.9%, from 4.8% recorded in FY'2021, attributable to a 0.7% increase in Trailing interest expense, relatively equivalent to a 0.7% decline in average interest bearing liabilities. Trailing interest expense refers to the performance of the interest expense for the past 12 consecutive months. Net Interest Margin (NIM) increased to 5.0%, from 4.2% in FY'2021 due to faster 18.2% growth in trailing Net Interest Income, coupled with a 0.2% decline in average interest-earning assets,
- Non-Funded Income (NFI) increased by 63.5% to Kshs 0.9 bn, from Kshs 0.5 bn in FY'2021, driven by a significant 182.0% increase in the group's foreign exchange trading income to Kshs 136.3 mn, from Kshs 48.4 mn in FY'2021, highlighting the group's increased foreign exchange margins, coupled with a 143.1% increase in other income to Kshs 441.0 mn, from Kshs 181.4 mn in FY'2021. Notably, total fees and commissions declined by 1.9% to Kshs 302.4 mn, from Kshs 308.4 mn recorded in FY'2021, mainly on the back of a 26.2% decline in other fees and commissions to Kshs 131.3 mn, from Kshs 177.9 mn in FY'2021. The revenue mix shifted to 71:29 from 77:23 funded to non-funded income, owing to the faster 63.5% growth of non-funded income (NFI), compared to the 18.2% growth in Net Interest Income (NII),
- Total operating expenses declined by 14.3% to Kshs 2.8 bn, from Kshs 3.3 bn in FY'2021, largely driven a 28.8% decrease in other operating expenses to Kshs 1.3 bn, from Kshs 1.9 bn in FY'2021, coupled with a 30.8% reduction in loan loss provision (LLP) to Kshs 0.2 bn, from Kshs 0.3 bn recorded in FY'2021, signifying reduced provisioning. The reduction in expenses was however weighed down by the 12.5% increase in the staff cost expense to Kshs 1.3 bn, from Kshs 1.2 bn in FY'2021,
- Cost to Income Ratio (CIR) improved to 93.5%, from 140.1% in FY'2021, owing to the 28.5% increase in total operating income, coupled with the 14.3% decline in total operating expenses. Without LLP, Cost to Income ratio also improved to 87.1% from 128.3% in FY'2021, an indication of improved efficiency,
- Profit before tax increased by 119.7% to Kshs 0.2 bn, from a loss before tax of Kshs 1.0 bn in FY'2021, with the effective tax rate rising to 39.5%, from 29.3% in FY'2021. Similarly, Profit after tax improved by 138.9% to Kshs 0.3 bn, from a loss after tax of Kshs 0.7 bn in FY'2021, a notable turnaround in full year profits, ending a four year loss making trend, and,
- HF Group's directors did not recommend a dividend payment for the FY'2022.

Balance Sheet

- The balance sheet recorded an expansion as total assets grew by 7.1% to Kshs 57.0 bn, from Kshs 53.2 bn in FY'2021, driven by a 30.4% increase in government securities to Kshs 8.5 bn, from Kshs 6.6 bn in FY'2021, coupled with a 4.6% growth in the loan book to Kshs 36.3 bn, from Kshs 34.7 bn in FY'2021,
- Total liabilities rose by 7.3% to Kshs 48.2 bn, from Kshs 44.9 bn in FY'2021, driven by a 5.5% growth in customer deposits to Kshs 39.8 bn, from Kshs 37.7 bn. Deposits per branch increased by 5.5% to Kshs 1.8 bn, from Kshs 1.7 bn in FY'2021, with the number of branches coming at 22 branches in FY'2022, unchanged from FY'2021,
- The 5.5% growth in customers' deposits outpaced the 4.6% growth in net loans, resulting in a decline in the loan to deposits ratio to 91.2%, from 92.0% in FY'2021,
- Gross Non-Performing Loans declined by 2.1% to Kshs 8.5 bn, from Kshs 8.7 bn in FY'2021, while gross loans increased by 4.7% to Kshs 43.0 bn from Kshs 41.1 bn in FY'2021. Consequently, the group's Asset Quality improved, with the gross NPL ratio declining to 19.7% in FY'2022, from 21.1% in FY'2021, higher than the average listed banks NPL ratio of 10.5% in FY'2022,
- NPL coverage improved to 78.8% in FY'2022, from 73.6% in FY'2021 mainly due to the 9.6% increase in General Provisions (LLP) increased by 9.6% to Kshs 3.9 bn, relative to the 2.1% decline in Gross Non-Performing Loans to Kshs 8.5 bn, from Kshs 8.7 bn in FY'2021
- Shareholders' funds increased by 6.0% to Kshs 8.8 bn in FY'2022, from Kshs 8.3 bn in FY'2021, supported by a 28.0% increase in revaluations reserves to Kshs 1.3 bn from Kshs 1.0 bn in FY'2021 and an 8.3% increase in statutory loan loss reserve to Kshs 3.7 bn, from Kshs 3.4 bn in FY'2021. However, the growth was significantly weighed down by the 0.7% increase in accumulated losses to Kshs 2.45 bn, from accumulated losses of Kshs 2.43 bn in FY'2021,
- HF Group remains undercapitalized with a core capital to risk-weighted assets ratio of 8.3%, 2.2% points below the statutory requirement of 10.5%. However, the total capital to risk-weighted assets ratio increased to 12.2% in FY'2022, from 12.1% in FY'2021, but remained short of the statutory requirement of 14.5% by 2.3% points. Adjusting for IFRS 9, the core capital to risk-weighted assets stood at 8.4%, while total capital to risk-weighted assets came in at 12.4%, and,
- The bank currently has a Return on Average Assets (ROaA) of 0.5%, and a Return on Average Equity (ROaE) of 3.1%.

Key Take Outs

1. **Full Year Profits** – HF Group made a profit after tax of Kshs 0.3 bn, a 138.9% increase from a loss after tax of Kshs 0.7 bn recorded in FY'2021, ending a four year loss making performance. The performance of the Group is attributable to efficient operations to minimize costs, evidenced by the total operating expenses declining by 14.3% to Kshs 2.8 bn, from Kshs 3.3 bn in FY'2021. Additionally, the Group's non-performing loans reduced resulting in reduction in loan loss provisioning,
2. **Improved Asset Quality** - The group's asset quality improved significantly, with the gross NPL ratio improving to 19.7% in FY'2022, from 21.1% in FY'2021, attributable to the 2.1% decline in gross non-performing loans to Kshs 8.5 bn, from Kshs 8.7 bn in FY'2021, coupled with 4.7% growth in Gross loans during the year to Kshs 43.0 from Kshs 41.1 bn in FY'2021. The asset quality improvement was a continuing trend from the Group's Q3'2022 performance where Gross NPL ratio came in at 20.3%, down from 22.0% in Q3'2021. Notably, on a q/q basis, HF Group's Asset quality improved by 0.5% points to 19.7%, from 20.3% recorded in Q3'2022,
3. **Sustained Efficiency** – Cost to Income Ratio (CIR) improved by 46.6% points to 93.5%, from 140.1% in FY'2021, attributable to the 28.5% increase in total operating income to Kshs 3.0 bn in FY'2022, from Kshs 2.4 bn in FY'2021, coupled with the 14.3% decline in total operating expenses to Kshs 2.8 bn, from Kshs 3.3 bn recorded in FY'2021. Key to note, this is the first full year that HF Group's total operating expenses have been lower than its total operating income, evidenced by the Cost to Income ratio of below 100.0% in all the four quarters of FY'2022,

4. **Cautious Lending** – HF Group's FY'2022 result was characterized by a faster 63.5% growth in government securities as compared to the 18.2% rise in net loans, depicting the group's adoption of conservative lending strategy to take advantage of the higher interest rates in Fixed Income, coupled with the fact that Real Estate credit risk remains elevated, with the Real Estate Gross Non-performing loans of Kshs 80.3 bn in Q4'2022 contributing to 16.5% of the total banking gross NPLs loans of Kshs 487.7 bn in FY'2022. Key to note, this was a 7.5% increase in Real Estate gross Non-Performing Loans from Kshs 74.7 bn in Q4'2021, compared to the total banking sector gross NPL loans of kshs 426.8 bn in FY'2021.

We commend HF Group's turnaround performance, recording a profit after tax of Kshs 0.3 bn in FY'2022, with the last full year profits earned in FY'2017 at Kshs 0.1 bn. Despite the four consecutive quarters of profitability witnessed in FY'2022, HF Group faces a major downside with its capital adequacy ratios remaining below the minimum statutory requirements set for banks. The group will have to review its business model or merge with a bank with stronger capital ratios so as to overcome its undercapitalization

Valuation Summary

- We are of the view that HF Group is a **"Sell"** with a target price of Kshs 3.9 representing an upside of 2.0%, from the current price of Kshs 3.8 as of 31st March 2023,
- HF Group is currently trading at a P/TBV of 0.2x and a P/E of 5.6x vs an industry average of 0.2x and 4.4x, respectively.